February 1, 2005

The Honorable John McCain, Chairman
The Honorable Byron Dorgan, Vice-Chairman
The Honorable Daniel Inouye, Member
Committee on Indian Affairs
United States Senate
836 Hart Office Building
Washington, DC 20510

Re: Contract review and IGRA's sole proprietary interest requirement

Dear Senators:

This is in response to the December 15, 2004, letter of Senators Campbell and Inouye, then the Chairman and Vice-Chairman, respectively, of the Committee on Indian Affairs. The letter expresses concerns about the National Indian Gaming Commission's review of gaming-related contracts for violations of the sole proprietary interest requirement of the Indian Gaming Regulatory Act ("IGRA"). Senator McCain has previously expressed interest in this issue in the context of the Mohegan Sun Management contract. We appreciate the concerns of the Committee. Consequently, we thought it might be helpful if we provided our thoughts on the issue.

Reduced to its essentials, the December 15 letter is concerned that the Commission's contract review has discouraged otherwise-willing contractors from working with Indian tribes, and thus has deprived the tribes of opportunities to develop or expand casinos. The letter is further concerned that the Commission brought about that state of affairs by the *ad hoc* application of a new standard for violations of IGRA's sole proprietary interest requirement, without notice or guidance to the tribes or their contractors in a manner that is not subject to review, thus depriving all concerned of their statutory and constitutional protections under the Administrative Procedure Act.

We wish to assure you, Senators, that this is not the case. We believe that we have helped the tribes and that we have saved them tens of millions of dollars by providing guidance on this issue. In a nutshell:

- The Commission's review of gaming-related contracts is intended to assure that the Indian tribes are the primary beneficiaries of their gaming operations, as IGRA requires. Our review has identified for tribes casino development contracts that were not only illegal but also unconscionable. Proposed under the guise of mutually-beneficial ventures, some were so one-sided that the tribes would realize nearly nothing from the gaming operation.

- The Commission's review of contracts, which are voluntarily submitted by the parties, attempts to identify potential IGRA violations before they occur, and thus avoid both the necessity of enforcement actions against tribes and the myriad problems that can arise when parties suddenly discover that their operating agreement was executed in violation of applicable law. When our review identifies IGRA violations in contracts already in effect, tribes are often able to renegotiate them without our having to bring enforcement actions and interrupting casino operations.

- The Commission's review is not a new exercise, nor does it apply new standards, previously undisclosed. Since 1993, Indian tribes and their contractors have, at the Commission's encouragement, submitted some 440 contracts for review, specifically for a determination that they are not subject to, or that they comply with, IGRA's requirements for management contracts. The review for sole proprietary interest violations became part of this review about 6 years ago as the Commission became more and more concerned about contracts that included egregious terms benefiting contractors rather than tribes. Before that, the issue had lain dormant since January 1993, when the Commission, in adopting regulations on tribal ordinances, provided a formal statement on sole proprietary interest in the Federal Register and indicated that it would provide further guidance in individual cases.

- The Commission's review does not infringe on the rights of Indian tribes or their contractors. The Commission is charged with IGRA's enforcement, and I may bring enforcement actions for all IGRA violations, including the requirement that a tribe, in all of its contractual undertakings, maintain the sole proprietary interest in, and responsibility for, all gaming activity. This is so whether or not the parties have submitted their contracts for review. For every alleged IGRA violation, the parties are entitled to administrative review before the full Commission under the Administrative Procedures Act and to subsequent judicial review if they are still aggrieved.

A more detailed legal and factual discussion follows.

## Legal background

To begin with, IGRA requires, as one of the necessary conditions for a tribe to open and operate a casino, a gaming ordinance approved by me, as the Commission Chairman. 25 U.S.C. §§ 2710(b)(B); 2710(d)(1)(A). For approval of a gaming ordinance, IGRA requires, among other things, that "the Indian tribe will have the sole proprietary interest and responsibility for the conduct of any gaming activity." 25 U.S.C. § 2710(b)(2)(A). The Commission therefore adopted regulations providing that tribal gaming ordinances include a provision to that effect. 25 C.F.R. § 522.4(b)(1).

As such, should a tribe and a contractor execute an agreement that gives to the contractor some proprietary interest in the gaming operation, the agreement violates both the tribal gaming ordinance and IGRA, which empowers me to correct those, and all other, violations

through enforcement actions. Therefore, any agreement that violates IGRA's sole proprietary interest requirement places the tribe at risk of fines and closure of its casino.

That said, a complete discussion of the Commission's review of gaming-related contracts – agreements for the development and construction of casinos, loan agreements, gaming equipment leases, etc. – also requires a brief discussion of management contracts. As summarized above, the Commission's review of contracts for sole proprietary interest violations has long been part of a voluntary compliance program, namely the voluntary submission of management contracts by tribes and their contractors for a determination by the Commission that the contracts do not offend IGRA's stringent requirements. The Commission encourages this review in order to both advance IGRA's purposes and ensure compliance. Specifically, the Commission's review ensures that Indian tribes are the primary beneficiaries of their casinos and that enforcement actions for IGRA violations are avoided.

As you are aware, tribes and their contractors submit to me, as Chairman, all contracts for the management of Indian casinos, together with any collateral agreements, *i.e.* any agreement related to a management contract, or to the rights, duties, and obligations that a management contract creates. 25 U.S.C. § 2711(a); 25 C.F.R. § 553.2; 25 C.F.R. § 502.5.

IGRA has many strict requirements for the approval of management contracts, and a list of them is unnecessary here. Suffice it to say that a management contract that I have not approved is void, and management of a casino under a void agreement has a number of undesirable consequences. The tribe is subject to fines and the closure of its casino in an enforcement action; the contractor has to vacate the casino; the tribe has to run the casino by itself; and the contractor is subject to legal action to disgorge to the tribe the proceeds of the contract.

**The history of the Commission's voluntary contract review**

Given IGRA's restrictions on management contracts, and the consequences for managing without an approved contract, the Commission had, by 1993, received a number of requests for guidance on whether specific agreements were, under IGRA, management contracts that require approval and background investigations. Accordingly, on July 1, 1993, the Commission issued Bulletin 93-3, "Submission of Gaming-Related Contracts and Agreements for Review," which invited tribes and their contractors to submit what the December 15 letter calls "non-management contracts" – again, gaming equipment contracts, development agreements, loan agreements, etc. – to the Commission for review in order to determine if they were management contracts.

On October 14, 1994, the Commission issued Bulletin 94-5, "Approved Management Contracts v. Consulting Agreements (Unapproved Management Contracts are Void)," which provided additional guidance on the issue. Noting that what distinguishes a management contract from other gaming contracts "depend[s] on the specific facts of each case," the Commission restated its willingness to provide voluntary review. Tribes and their contractors did not hesitate to accept the Commission's offer. Since July 1993, the Commission has received some 440 requests to review contracts.

The Commission's review for violations of IGRA's sole proprietary interest requirement is simply a part of the voluntary review of gaming-related agreements that it has conducted for more than 11 years. The Commission reviews such agreements both to see if they are management contracts and to see if they violate the sole proprietary interest requirement.

The sole proprietary interest review has its origins in January 1993, when the Commission adopted regulations concerning, among other things, the submission, review, and approval of tribal gaming ordinances. In response to a specific inquiry by a commenter, the Commission provided guidance on the meaning of the sole proprietary interest requirement. The Commission found:

1. An agreement whereby consideration is paid or payable to the gaming operation for the right to place gambling devices that are controlled by the vendor in such gaming operation is inconsistent with the requirement that a tribe have the sole proprietary interest.

2. Regarding collateral loans, a tribe may not grant a security interest in a gaming operation if such an interest would give a party other than the tribe the right to control gaming in the event of a default by the tribe.

3. Because IGRA specifies that a tribe (not its members) must have the sole proprietary interest, stock ownership in a tribal gaming operation by individual tribal members would also be inconsistent with IGRA.

58 F.R. 5804 (Jan. 22, 1993).

Having said this, the Commission felt further general guidance to be inappropriate, but concluded with a public offer to "provide guidance in specific circumstances" upon request. *Ibid.*

**Results of the Commission's contract review:**
**Tribes are the primary beneficiaries of their casinos**

Far from shutting down opportunities for tribes to build or expand casinos, the review of contracts, both for management contract and sole proprietary interest violations, has, without exaggeration, saved Indian tribes tens of millions of dollars. In so doing, review has helped ensure that tribes are the primary beneficiaries of their casinos, as IGRA intends. 25 U.S.C. § 2702(2).

The Commission has, for example, discovered agreements under which contractors have tried not only to take financial advantage of tribes but also to subvert IGRA's requirements for management contracts and for regulatory oversight. Contractors have presented tribes with so-called "consulting agreements" by which they offered to "assist" tribes in building and running a casino. Representative of such agreements is compensation of 35% of a tribe's net gaming revenue for a period of 5 to 7 years, well in excess of IGRA's 30% cap on compensation from net revenue in management agreements. 25 U.S.C. § 2711(c)(1). The contrac-

tors also insisted on preferential payments, *i.e.* payments from the tribe before all obligations other than operating expenses, and thus create the possibility that the tribe is left with very little or is left in debt to the contractor.

Contractors have attempted to safeguard their financial interests by arrogating to themselves significant management responsibilities, while at the same time claiming that the "consulting agreement" is not a management contract and not subject to my approval. Those management responsibilities have included such things as appointing the casino's general manager, who has direct supervisory authority over all casino departments and employees; developing the casino's internal controls; developing the casino's budget; deciding which games to offer; and directing casino marketing and advertising.

As the Commission's review and analysis developed, it prevented this kind of contract from ever taking effect, or allowed tribes to renegotiate such contracts if they had already been signed. As a result, the tribes have remained in control of, and have remained the primary beneficiaries of, their casinos. When notified that such agreements appeared to be management contracts that did not meet IGRA's limitations on payment from net revenues, or other of its stringent requirements, tribes were able to negotiate more favorable financial arrangements and realized savings of millions. In addition, contractors were prevented from managing Indian casinos without first undergoing the necessary background checks and suitability determinations. 25 U.S.C. § 2711(e). The Commission's review has thus advanced another of IGRA's essential purposes. It has ensured that casinos, and those who manage them, are free from corrupting influences. 25 U.S.C. § 2702(2).

As contractors realized that they were no longer able to circumvent management contract review by calling a contract a "consulting agreement" or a "development agreement," they began eliminating provisions that allowed them to control the day-to-day operations of casinos. In other words, they began to look for other ways to extract large sums of money from tribes without taking on responsibilities that would raise red flags in a review for management contracts.

This change in approach led the Commission to realize that some contractors were apparently receiving an ownership interest in tribal casinos because they were certainly not providing services worth the enormous sums of money they were receiving. By reviewing contracts for sole proprietary interest violations as well as management contract violations, the Commission has saved tribes many more millions of dollars.

In one agreement, for example, the tribe had a 10-year obligation to pay its contractor 35% of its net gaming revenues each month as so-called "rent" for gaming equipment and the casino building, all of which the tribe had already paid for in full within the first 6 months of the 10-year term.

In an even more egregious example, the tribe had a 5-year obligation to pay rent equal to all of the developer's costs, plus interest, plus an additional "rent" of 75% of net revenue. Following that, the tribe had a 10-year obligation to pay 16% of gross revenue, an amount

roughly equal to 50% of net revenue, and all of these payments were to be made long after the developer ceased providing services of any kind.

These agreements, and others like them, violate IGRA's sole proprietary interest requirement because the developer's compensation is paid from the casino's profits, and it is paid in such a way and in such quantity as to bear little or no relationship to the value of the services provided or to the risk assumed. Rather, profits are distributed to the developer as to one with a fractional ownership interest -- a proprietary interest – in an enterprise and its profits. The Commission's review has enabled tribes to avoid such illegal and unconscionable agreements and has thus assured that they are the primary beneficiaries of their casinos.

**Results of the Commission's contract review continued: Enforcement actions are unnecessary**

The Commission's review of gaming-related contracts, again, whether for management contract or sole proprietary interest violations, is sound regulatory practice with a number of other straightforward, beneficial effects. By identifying IGRA violations before they occur, enforcement actions are not required, nor are the fines of up to $25,000 per day or the closure of casinos. 25 U.S.C. § 2713(a)-(b). By identifying violations in contracts soon after execution, we are often able to negotiate resolutions without the need for enforcement actions. Whenever violations may be discovered, by proceeding in this way, the parties are able to avoid the uncertainty and loss of business occasioned by formal action taken against tribes for contracts executed in violation of applicable law.

**Due process**

Finally, the Commission's review does not infringe upon the rights of tribes or their contractors. My authority is explicit in IGRA. Without limitation, I am empowered to bring enforcement actions against all IGRA violations. 25 U.S.C. § 2713.

Again, however, one of the purposes of contract review is to eliminate IGRA violations and thus to avoid enforcement actions whenever possible. Doing so by means of an advisory opinion in response to a voluntary request for review violates no one's rights.

I want to stress again that our review is informal and voluntary. The parties are not obliged to seek review, nor are they obliged to heed our advisory opinion if they do. Indeed, in the rare instances when the Commission has reached out and asked to review contracts, the request is, of necessity, still voluntary. We have no jurisdiction over the contractors to compel their compliance, and we have brought no enforcement actions against the tribes pursuant to which we might compel them to submit contracts. The tribes and their contractors are free to decline our request, just as they are free not to seek an advisory opinion in the first place. As such, our review is an informal, prophylactic exercise that seeks negotiated solutions rather than formal enforcement. In other words, our review simply does not implicate the parties' statutory or constitutional rights.

The Commission is at great pains, however, to protect those rights when voluntary, cooperative action ceases and I bring a formal enforcement action. The parties are then entitled to complete review before the full Commission under the Administrative Procedures Act, and they are entitled to subsequent judicial review in District Court if they are still aggrieved. 25 U.S.C. §§ 2713(a)(2), (3); 2713(b)(2); 2713(c).

Given, then, the advisory nature of the Commission's contract reviews, and given the full panoply of administrative and judicial review available to aggrieved parties, the statutory and due process rights of the tribes and of their contractors are not infringed in any way.

In conclusion, I hope that our explanation provides you with a more complete understanding of our reasons for addressing the sole proprietary interest issue in the manner that we have. I would be most pleased to meet with you personally to discuss this matter further, or any other matter of concern to the Committee. I thank you for your time, interest, and concern.

Sincerely,

/s/ *Philip N. Hogen*

Philip N. Hogen
Chairman